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In the Supreme Court of the United States

OCTOBER TERM, 1971

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-522

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. App. B 1-11) is reported at 444 F. 2d 1102.

JURISDICTION

On July 14, 1971, the Court of Claims granted the government's motion for partial summary judgment and dismissed petitioner's claims to the extent that they are inconsistent with the court's opinion

(Pet. App. B 1, 11). The petition for a writ of certiorari was filed on October 12, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1255 (1).

QUESTIONS PRESENTED

1. Whether petitioner incurred amortizable bond discount in a 1947 reorganization under Section 77 of the Bankruptcy Act when it issued new bonds and stock in exchange for outstanding bonds and cancellation of bank loans, and the maturity value of the new bonds was less than the principal amount of the total old debt.

2. Whether petitioner incurred amortizable bond discount in 1956 when it issued new debentures and common stock in exchange for old preferred stock which had been issued in the 1947 reorganization, where the maturity value of the new debentures was equivalent to the par value of the old preferred stock, and petitioner had received more than full consideration for the issuance of the latter.

3. Whether the court below properly refused to consider on its merits a contention not raised by petitioner in its claims for refund.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutory and regulatory provisions are set forth in Appendix A to the petition (Pet. App. A 1).

STATEMENT

The exchange of bonds for debt in the 1947 reorganization

In a 1947 reorganization under Section 77 of the Bankruptcy Act (11 U.S.C. 205), petitioner issued its new bonds, stock and cash in exchange for its outstanding bonds and cancellation of bank loans, plus accrued interest ("old debt"). The face value of the old debt was $363,789,651. The maturity and par value of the new securities was $244,856,494, of which $120,935,000 was the maturity value of the new bonds. At the time of the 1947 exchange, the market value of the new bonds, as quoted on the New York Stock Exchange, was $91,866,411. (Pet. App. B 2-3.)

Petitioner argued that the market value of the old debt was established by the quoted value of the new bonds, on the assumption that fair market value equivalents were exchanged, and contended that the difference between the value thus attributed to the old debt ($91,866,411) and the maturity value of the new bonds ($120,935,000) constituted amortizable bond discount. The court held that there was no discount because petitioner gave up no more value than it received when it issued new bonds having a maturity value less than the maturity value of the old debt that was cancelled. (Pet. App. B 2-3.)

The 1956 exchange of debentures and common stock for preferred stock

In the 1947 reorganization, petitioner had issued five percent preferred stock with a par value of $33,129,000. In 1956, in a recapitalization described in

Section 368(a)(1)(E) of the Internal Revenue Code of 1954, petitioner exchanged five percent debentures with a maturity value of $33,129,000, plus 82,823 shares of no par common stock, for the five percent preferred stock, which was cancelled and retired. The holders of the preferred stock thus received a $100 maturity value debenture for each $100 par value share of preferred stock surrendered, plus one-quarter share of common stock. (They also received in cash the unpaid portion of accrued dividends on the preferred stock.) At the time of the 1956 exchange, the market value of the old preferred stock, as quoted on the New York Stock Exchange, averaged $22,908,148.35. (Pet. App. B 3-4.)

Petitioner contended primarily that the difference between the market value of the redeemed preferred stock ($22,908,148.35) and the maturity value of the new debentures ($33,129,000) constituted amortizable bond discount. The court, noting (Pet. App. B 4) that the maturity value of the new debentures was less than the consideration received by petitioner on issuance of its preferred stock in 1947, held (Pet. App. B 5) that no discount was incurred in the exchange of debentures for the preferred stock, since "there was an exchange of equals" in which petitioner "got back one $100 par value share of preferred stock for each $100 debenture given up."

Petitioner also contended that, even if the preferred stock had the same value as the new debentures, it incurred bond discount to the extent of the value of the new common stock issued in the 1956 exchange. The court rejected this contention on the

ground that the issuance of common stock does not create a definite repayment obligation that can give rise to bond discount expense (Pet. App. B 6). Finally, the court pointed out that if petitioner was entitled to bond discount deductions, the preferred stockholders would, as a necessary corollary, realize interest income. But the court found that the preferred stockholders neither believed, nor were given reason to believe, that they would be realizing interest income by reason of the issuance of common stock, and held (Pet. App. B 7) that petitioner "cannot alter or repudiate its bargain to the detriment of the other side of the exchange, at this late date, in order to obtain a tax advantage for itself."

The sufficiency of petitioner's claims for refund with respect to another issue

In 1959, 1960 and 1962, petitioner realized gains when it reacquired for less than face value some of the debentures issued in 1956. As permitted by Section 108(a) of the Code, petitioner elected to have these gains excluded from income and applied in reduction of the tax basis of its property. The Commissioner determined that the gains on reacquisition should reduce the basis of so much of petitioner's property as was subject to ratable depreciation. In its claims for refund and complaint, petitioner asserted only that the gains should reduce the basis of the preferred stock surrendered and cancelled in the 1956 exchange. (Pet. App. B 7-10.)

Petitioner contended for the first time on brief that if the basis of depreciable property, rather than

preferred stock, was to be reduced, the reduction should not be limited to property subject to ratable depreciation, but should also include property subject to the retirement-replacement method of accounting. The court ruled that the gains could not be applied in reduction of the basis of the preferred stock because that stock had ceased to exist in 1956. It refused to consider petitioner's alternative argument on the merits because it had not been raised in the claims for refund. (Pet. App. B 8-10.)

ARGUMENT

The decision below is correct. There is no direct conflict on any of the issues raised, and no other reason for further review.

1. The question whether petitioner incurred bond discount in the 1947 reorganization is essentially the same as the issue raised in *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, modified on reconsideration, 433 F. 2d 1324 (Ct. Cl.), certiorari denied, 402 U.S. 944. We discussed the nature of bond discount at length in our brief in opposition in that case (No. 1333, 1970 Term), on which we here rely.[1] It is sufficient to reiterate as a general matter only that bond discount ordinarily arises where bonds are issued for a cash amount which is less than the face amount of the bonds; that it is amortizable by the issuer ratably over the life of the bonds as the

[1] Copies of the brief were served on counsel for petitioner herein, who also was counsel for the taxpayer in *Missouri Pacific*.

equivalent of additional interest expense; and that its accrual or receipt by the bondholder is treated as additional interest income. See *Helvering* v. *Union Pacific Co.*, 293 U.S. 282; *United States* v. *Midland-Ross Corp.*, 381 U.S. 54.

In 1947, petitioner issued new bonds in exchange for its old debt of equivalent or greater maturity value, but obtained no new capital in the transaction. It contends (Pet. 11) that it should be treated as if it had issued the new bonds for cash, and then used the proceeds to buy back the old debt in a separate transaction, with the result that it incurred discount measured by the excess of the face amount of the new bonds over the fair market value of the old debt. But this Court has refused to apply petitioner's two-step analysis in similar circumstances, and has held instead that there was a mere substitution of obligations which required the debtor corporation to carry over unamortized discount on the old bonds and to amortize it over the life of the new securities. *Gt. W. Power Co.* v. *Commissioner*, 297 U.S. 543, 546.

This rationale is applicable here. Where, as here, a corporate debtor issues new bonds in substitution for old bonds of equivalent or greater maturity value, bond discount cannot be determined by reference to the market value of the old debt which is extinguished in the exchange. This value is meaningless to the debtor because the old debt is no longer subject to market conditions, and the debtor is in no worse position after the exchange than it was previously—the amount of its assets has not been reduced,

and its obligation to pay has not been increased. To recognize bond discount in these circumstances would permit a corporate debtor to generate income tax deductions merely by a paper reshuffling of its financial structure, but without any real change in that structure. It would "give credence to an illusional or fictional interest charge which does not actually exist. * * * [Petitioner] would be unjustly increasing the amount of its deductions without correspondingly increasing its obligations." *Missouri Pacific Railroad Co.* v. *United States*, *supra*, 427 F. 2d at 731.

2. For similar reasons, bond discount on the 1956 exchange cannot be determined by reference to the fair market value of the preferred stock surrendered in the exchange. This value is as meaningless to petitioner as the value of the old bonds surrendered in 1947. The critical fact is that petitioner merely reshuffled its financial structure by substituting a $100 debenture for each $100 par value of preferred stock previously outstanding. As the court below recognized (Pet. App. B 4-5), this was an exchange of equivalents so far as petitioner was concerned. Given the fact that the consideration received by petitioner upon issuance of the preferred stock in 1947 was equal to, or in excess of, the maturity value of the new bonds, it suffered no loss and no actual or anticipated expense when it issued the new bonds. It follows that petitioner did not incur bond discount in the 1956 transaction.[2] See *Erie Lackawanna R.R.*

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[2] The Court of Claims alternatively reached the same conclusion (Pet. App. B 5-6) in reliance on the fact that petitioner had represented to its shareholders that the 1956 ex-

v. *United States*, 422 F. 2d 425 (Ct. Cl.); *National Alfalfa Dehydrating and Milling Co.* v. *Commissioner*, 57 T.C. No. 6, decided October 14, 1971.

Contrary to petitioner's assertions (Pet. 8, 12), it is immaterial that cash and common stock were issued, together with bonds, in the 1956 exchange. The cash was only the unpaid portion of the dividends on the preferred stock (Pet. App. B 4), and did not represent a reduction in petitioner's assets attributable to the redemption of such stock. Nor were petitioner's assets reduced or its obligation to pay increased by the issuance of common stock, since the latter, by its very nature, is not a fixed obligation which increases corporate indebtedness. At all events, as the court below explained (Pet. App. B 6-7), it would be unfair to allow petitioner to obtain a tax advantage in the form of bond discount deductions, which would require as a consequence that the old preferred stockholders realize additional interest income, when petitioner gave them no reason to believe that a discount arose as a result of the issuance of common stock. See *Commissioner* v. *Danielson*, 378 F. 2d 771 (C.A. 3), certiorari denied, 389 U.S. 858;

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change would increase its after-tax earnings (available to common stockholders) by more than $800,000 per year. (The projected increase results from the fact that the five percent stated interest on the new bonds would be deductible and would produce a tax benefit, while the five percent dividend on the same face amount of preferred stock was not deductible.) The court reasoned that since the effect of the exchange was to increase petitioner's earnings substantially, the stock received by petitioner could not be worth less to it than the face amount of the debentures issued, and therefore, that no discount was incurred.

Bethlehem Steel Corp. v. *United States*, 434 F. 2d 1357 (Ct. Cl.).

3. There is no conflict with *Atchison, Topeka and Sante Fe R. Co.* v. *United States*, 443 F. 2d 147 (C.A. 10), as petitioner claims (Pet. 6). In that case, the Tenth Circuit determined bond discount by reference to the market value of the old securities. But the facts were not comparable to those here. *Atchison* involved an 1895 equity reorganization in which the predecessor and successor companies were different corporate entities. There was an exchange of the bonds of one taxpayer for the assets or securities of another, not a mere substitution of securities within a single corporation. And the Tenth Circuit pointed out that the transaction there in question predated the enactment of the income tax laws, so that the parties, at the time of the transaction, did not have competing tax interests. These considerations and others led the Tax Court recently to conclude in a unanimous reviewed opinion in *National Alfalfa, supra*, that the holding in *Atchison* did not apply in a transaction identical in all salient respects to petitioner's 1956 exchange. Appeal in *National Alfalfa* lies to the Tenth Circuit. To the extent, therefore, that petitioner relies on the views of the Tenth Circuit to establish conflict, it will be time enough to consider whether review by this Court is appropriate if the decision in *National Alfalfa* is reversed.

There is likewise no conflict with *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883 (C.A. 3). Although, as petitioner points out (Pet. 6-7), the court there valued stock for which new

bonds were issued by reference to market quotations, the facts again are significantly different from those in the instant case. *American Smelting* involved an exchange of the taxpayer's bonds for the preferred stock of its subsidiaries—not, as here, substitutions of the issuer's bonds for its own debt and securities of equal or greater value. Moreover, *American Smelting* was decided before this Court held in *United States* v. *Midland-Ross Corp.*, *supra*, that, to the extent of discount, a bondholder realizes a corresponding amount of interest income. It is doubtful whether the Third Circuit would reach the same result today, in the light of *Midland-Ross* and its own subsequent ruling in *Commissioner* v. *Danielson*, *supra*, that it is not the function of the courts to fashion a new bargain for parties to a contract who have competing tax interests. In *American Smelting*, the parties made no provision for bond discount.

There is not even an arguable conflict with *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (C.A. 2), upon which petitioner also relies (Pet. 7). In that case the taxpayer purchased inventory at an agreed price of $100,000, issuing therefor one hundred $1,000 debenture notes. Each note provided for yearly increases in the redemption price. These increases obviously represented the cost of borrowing rather than payment of the agreed purchase price, and the court properly held that the increases constituted amortizable discount.

4. As petitioner notes (Pet. 9-10), and as we acknowledged in our brief in opposition in *Missouri Pacific Railroad Co.* v. *United States*, *supra*, there is

some confusion among the courts concerning the circumstances under which bond discount may be incurred. The matter continues to be of administrative importance notwithstanding the provisions added to the Internal Revenue Code by the Tax Reform Act of 1969 as to bonds issued after May 27, 1969 (Section 1232(b) of the Code, as amended by Section 413(b) of P.L. 91-172, 83 Stat. 609). But this is not an appropriate case for certiorari because it is clear that petitioner did not issue new bonds with a value greater than the value to it of its old securities. Hence, under any theory, petitioner did not incur bond discount expense as a result of either the 1947 or 1956 transaction.

5. Finally, petitioner contends (Pet. 12-14) that the court below erred in holding that its claims for refund did not set forth its alternative ground for recovery in connection with the allocation of basis adjustments. This issue, turning as it does on a reading of the claims for refund, and the question whether the language of the claims was sufficient to call the Commissioner's attention to the alternative ground for recovery, is not worthy of this Court's review. In any event, the court below, after carefully considering the claims, and noting that petitioner did not refer to the alternative argument either in the claims or in its complaint, correctly held (Pet. App. B 7-11) that the claims were insufficient, and, therefore, that petitioner was barred from raising the issue on brief. See *Real Estate-Land Title & Trust Co.* v. *United States*, 309 U.S. 13; *United*

States v. *Garbutt Oil Co.*, 302 U.S. 528, 531-532; *United States* v. *Andrews*, 302 U.S. 517 .

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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